ORIGINAL

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In re the Matter of	)	
	)	MM Docket No. 94-123
Review of the Prime Time Access Rule,	)	
Section 73.658(k) of the Commission's Rules	)	

REPLY COMMENTS

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I. OVERVIEW

The Coalition to Enhance Diversity has asked us to review and analyze the economic reports filed in this proceeding by (1) the Law & Economics Consulting Group ("LECG") on behalf of INTV, King World and Viacom,[1] (2) Economists Incorporated ("EI") on behalf of Capital Cites/ABC, CBS, and National Broadcasting Company,[2] and (3) the Staff of the Federal Trade Commission.[3] We do not believe that these reports provide a reasoned economic justification for either the retention of PTAR's off-network restriction, or the immediate repeal of the Rule's network restriction.

A. The Off-Network Restriction

Although the LECG report purports to be a welfare analysis that is based on considerations of efficiency, market failures, public goods, and the like, in fact the report is predominantly concerned with preserving the current redistributional effects of PTAR. We reach this conclusion for several reasons.

For one thing, although LECG makes repeated references to "viewer welfare," the welfare function according to which viewer welfare is to be judged is never disclosed. Nor are we ever advised as to how the cost differences associated with different PTAR restrictions figure into the calculus (if at all). In the absence of a specification of the undisclosed welfare function

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[1] Economic Report: The Economic Effect of Repealing the Prime Time Access Rule: Impact on Broadcasting markets and the Syndicated Program Market, Law & Economics Consulting Group, March 7, 1995.

[2] An Economic Analysis of the Prime Time Access Rule, Economists Incorporated, March 7, 1995.

[3] Review of the Prime Time Access Rule, Section 73.658(k) of the Commission's Rules: Comments of the Staff of the Bureau of Economics of the Federal Trade Commission, March 7, 1995.

out of which they are working, and an indication of whether that function makes allowance for the cost effects to which we refer, it is impossible to ascertain from their report whether "viewer welfare would suffer as a result of repealing PTAR."[4]

What is clear to LECG is that the viability of some independent stations is dependent on the continuation of PTAR. But exactly why public policy should be concerned about the viability of marginal independent stations after 25 years of PTAR is unclear. It is elementary that marginal firms that have been unable to cross the threshold of viability after many years of support eventually lose their entitlements to protective measures. The term "infant industry," after all, contemplates that small and inexperienced firms may, if granted a window of opportunity, develop the requisite size and capabilities to make it against established rivals. But there are no guarantees and sometimes those hopes are not realized. Often only some of the protected firms rise to the occasion. Understandably, however, high-cost fringe firms that need protection to remain viable petition for an indefinite continuation of the protection. That is not asking for a window. That is a gaping hole in the fabric of an enterprise system.

The basic rationale behind infant industry protection is to promote efficiency. Firms that try but do not succeed should recognize that they are a high-cost burden on society. Their appeal for continuing protection should then be seen for what it is: a request for a redistributional result that carries a burden of inefficiency.

To be sure, that does not condemn all such requests. Certainly much of politics has the purpose and effect of awarding high-cost redistributional favors. In this instance, however, the FCC clearly declares that its purpose is "not to maintain an inefficient distribution scheme that

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[4] See LECG, at p. ix.

favors [certain competitors]."[5]

Although we believe that the LECG report has one clear message–namely, to continue redistributional relief in favor of the marginal stations–that is somewhat obscured by their presentation which makes repeated references to "market failures" (even "classic market failures") and "public goods" and "anti-competitive concerns." Merely to employ efficiency jargon, however, does not a coherent efficiency argument make.

LECG never, for example, faces the fact that television fails to fulfill the requisites of a public good–to wit, a good that is both "nonrivalrous" (one person's consumption does not diminish the availability of the good to others) and "nonexcludable" (it is prohibitively costly to prevent others from consuming the good). Television, however, has mixed features in these respects. Thus, although broadcasting is nonrivalrous, it can be made excludable (*e.g.*, pay cable channels and scrambled DBS signals). Moreover, spectrum is rivalrous (*e.g.*, with respect to interfering signals).

Were it that television was a true public good, there would be a strong case for producing it under government auspices and supporting it with tax receipts (ideally, of a lump-sum kind). Were it that television was a natural monopoly, there would be a strong case for rate-of-return or price-cap regulation. The fact that television is organized in a mainly competitive milieu, rather than as a public good (e.g., national defense) or as a public utility, speaks to the inappropriateness of the public good digression. Analytically, the public good gambit is a "red herring."

Indeed, a careful examination of the cost and demand conditions of programming reveal

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[5] See NPRM, at p. 21, n. 71.

that it displays the characteristics of a private good.[6] Nevertheless, LECG concludes that corrective action is warranted, leading to its support for retention of PTAR. We never learn, however, how PTAR specifically addresses the public good aspects of any of the various television markets. While LECG sees PTAR as an appropriate remedy for the public good ills caused by television, they never explain how this particular set of rules operates to correct any inefficiencies. For example, we do not learn what it is about PTAR's special treatment of off-network programs compared to first-run syndicated programming, and of network affiliates compared to independent stations, that specifically addresses the public good aspects of television. Instead, LECG uses the mention of public goods as a black hole to provoke concern, but from which no added understanding is derived whatsoever.

LECG's references to market failure are especially obscure. What are the alternatives in relation to which the market fails? That the television market is flawed in relation to a hypothetical ideal is not a suitable test if all feasible alternatives are flawed in relation to that criterion. In that event, what is needed is the identification and description of the alternative feasible forms from which choices are to be made, warts and all. Because, however, the feasible alternatives with respect to which LECG would make a comparison are never even identified, the exercise is truncated.

Indeed, truncated reasoning is a repeated feature of this report. Thus, protection is evidently warranted indefinitely, forgetting that reasoned infant industry arguments necessarily expire. And market failures are never developed in a comparative institutional way, so the relevant feasible alternatives are never examined in a careful side-by-side comparison. The exit of marginal firms upon the phasing out of infant industry protection is treated not as a gain but as a "loss of competition." Numbers of firms, rather than their efficacy, evidently play a

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[6] The good that LECG proposes to use as a means to delineate television markets–national advertising–is clearly a private good as well, despite being an integral part of the television package.

significant role in LECG's welfare function.

Their treatment of investments is illustrative. LECG contends that investment is "biased" against quality first-run syndicated programs because they "need higher ratings in order to compete with lower cost off-network programs."[7] But what does this mean in an intertemporal context in which off-network programs must first incur the cost of being produced for network runs–not all of which original runs succeed. Syndicated programming competes with network programming, where the greater costs of the latter are justified in part by the prospect that successful network programs can be sold as off-network programs, the added revenues from which will exceed their marginal costs in the off-network market. Plainly a snapshot of costs at a point in time does not capture the flow of net receipts that are the key to informed investments.

LECG's interest in redistribution shows up as well in their empirical analysis of the off-network restriction. They estimate relationships between the number of independent stations and their performance and various market variables and PTAR effects. A crucial aspect is recognition of differences across independent stations. When we allow for performance of stations to vary, our estimates reveal that PTAR has differential impacts on marginal as compared to established independents. In particular, when we control for the "age" of the station, we find that experienced stations are the principal recipients of the benefits of PTAR. Marginal stations were nevertheless attracted to the television business especially since 1980. However, every indication points to the fact that, while they may have been attracted by the high ratings of their established counterparts, entry by these marginal stations was simply a product of the FCC's frequency allocation plan and the growth of cable. The new entrants usually began with a UHF channel, and while we find that ratings tend to be systematically

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[7] See LECG, p.__.

lower in that band compared with VHF, any deficit can be overcome with several years of business experience.

More generally, the LECG analysis of the off-network restriction is piecemeal throughout. In the end, the pieces do not come together to form a reasoned efficiency assessment. Continued redistribution is what this report is all about.

B. The Network Restriction

As discussed in Section V.C of our earlier Comments,[8] we ascribe diversity benefits to the network restriction. Partly that is because the network restriction helps to solve a collective action problem, but mainly that is because markets and hierarchies differ in kind, there being a greater propensity to exercise control under hierarchy. Since, moreover, affiliates can opt out of the network feed only with difficulty, and because efforts by the networks to replicate the benefits of PTAR on a "voluntary" basis lack credibility, we conclude that the network restriction should be continued–at least for the present.

Our argument, it will be noted, is not an infant industry argument. It is a diversity argument and turns on the differential propensity of alternative modes of contracting to support autonomy, depending on whether the network restriction is in effect or not.

Although the comments of the Staff of the Federal Trade Commission relate to these issues,[9] the FTC Staff Report proceeds "as if" these two forms of contracting differ in inconsequential ways. There is reference, for example, to the "same market forces" for both

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[8] A Comparative Efficiency Analysis of the FCC's Prime Time Access Rule, Oliver E. Williamson and Glenn A. Woroch, March 7, 1995.

[9] See especially FTC at pp.20-21.

station managers and network executives;[10] and the FTC contends that the principal obstacle to joint profit maximization is that of redistribution.[11] In other respects, however (that is, distributional considerations aside), the FTC Staff presumes that the parties would come out similarly. We agree that the distribution of the pie is a pertinent consideration, but the more basic proposition is that different decision-making structures will often reach different diversity results. The FTC Staff ignores this point.

The EI report also addresses the network restriction.[12] Mainly, theirs is an empirical assessment of welfare losses, the adequacy of which we examine below. What concerns us here is their failure to support their claim about "the lack of network control over affiliates' program choices."[13] Although a literal reading of the contract may support that conclusion, the need is to understand the way the contracting process works in fact. *De facto* trumps *de jure* when the two differ in making informed public policy decisions. Also, their discussion, like that of the FTC, makes no provision for the diversity differences that obtain by reason of the inability of the networks to replicate the affiliates in their contracting relations with producers.

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All together, we conclude that the LECG report does not subscribe to the efficiency purposes to which the FCC refers in the NPRM. And while the FTC Staff and EI reports are better in this respect, neither of these engages the organizational issues that are pertinent to an assessment of the network restriction. On our reading, the LECG report should be interpreted

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[10] Id., p.20.

[11] Id., p.21.

[12] See EI at pp. 21-23 and 31-41.

[13] See EI, p.23.

principally as a plea to confer continuing infant industry protection for marginal independent stations. The efficiency basis for such an infant industry argument having expired, the LECG report is a request for redistributional favors. That the FTC staff and EI do not address the diversity differences between alternative modes of contracting (markets versus hierarchies) is because these differences are assumed to be nil. For the reasons given in our report, we hold otherwise. Accordingly, we recommend that PTAR be addressed in two stages: the off-network restriction (which is where the infant industry argument applies) should be terminated now; and the network restriction (where the diversity issues are concentrated) should be retained for the time being and revisited in light of future changes in the television industry to determine whether maintenance of this restriction continues to be warranted.

II. CONCEPTUAL ANALYSIS OF THE LECG REPORT

We now turn to a detailed analysis of the comments filed by other parties in this proceeding. Our principal concern will be the report filed by LECG on behalf of INTV, King World and Viacom. We confine our remarks in this section to conceptual issues; our critique of the empirical work in these studies follows, including the treatment of the network restriction in the report filed by Economists Incorporated.

A. LECG's Mischaracterizes Television as a Public Good

The starting point for the LECG analysis is an improperly functioning television and program market in need of regulatory intervention. At various points, the LECG report summarily characterizes television markets as involving a "public good" and occasionally refers to the presence of "market failures." We will take up the issue of market failure connected with the program market below. For now, we wish to address the question of whether television is

a public good, a type of good that traditionally invites government intervention to achieve efficiency.

First of all, LECG wrongly characterizes television as a public good. Two properties define a public good: (i) "nonrivalry" which means that one person's consumption of the good does not reduce its availability to another person; and (ii) "nonexcludability" which means that it is not possible to prevent someone from consuming the good. Television viewing is nonrivalrous but certainly excludable. It is nonrivalrous because one person's viewing of a program does not diminish another person's opportunity to view that same program.[14] It is excludable, however, since viewers can be prevented from consuming by electronic scrambling of the signals, or by narrowcasting over a cable so that only households and stations that are equipped with decoders and descramblers can receive the signal.[15]

Instead, the LECG report (and the EI report as well) chooses to characterize television as a public good for the simple reason that it has high fixed costs and negligible marginal costs.[16] In the limit this leads to natural monopoly. But high fixed costs and negligible

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[14] This is in contrast to a private good (e.g., a slice of bread) where once a portion is consumed by one person, that portion is no longer available for consumption by another.

[15] It is true that the Commission does not allow over-the-air broadcasters to scramble their signals except in the few cases where subscription television is permitted, so that while over-the-air broadcasts are excludable in theory, they are not excludable by regulation. However, DBS and cable systems scramble or encrypt their signals, and we consider these video services to compete directly with over-the-air broadcasts for viewers, and hence, for advertising dollars. Therefore, it is fair to say that delivery of video signals to viewers is excludable in practice as well. Owen and Wildman (1994) explicitly recognize this point when they state "If a program is broadcast, the broadcast itself is a public good, at least within the geographical area of the signal and, *if scrambled, to those with a descrambler*" (p.24, emphasis added).

[16] Owen and Wildman, who are associated with the EI and LECG reports, respectively, claim that the electromagnetic spectrum as one reason that broadcasting qualifies as a public good. There may be free access to the spectrum but it is not nonrivalrous. Two services cannot occupy the same frequencies in the same community at the same time without creating radio interference.

marginal costs are properties of many products not usually considered public goods: books and magazines, nuclear power, computer software, to name a few. Furthermore, LECG does not supply convincing evidence that the marginal cost to deliver signals to a expanded area, or to entice larger audiences to tune-in by providing popular programming, is all that small.[17]

LECG's characterization of television as a public good market is not only wrong, but it leads them to a contradictory policy prescription. Whereas industries that experience large fixed costs and negligible marginal costs will sometimes warrant entry barriers to preclude redundant entrants, LECG clearly favors regulations that promote unlimited entry into such an industry.[18]

By suggesting that the pursuit of large numbers of competitors is an appropriate objective for the FCC, LECG implicitly assumes that more rivals means improved industry performance. This predilection is revealed in their obsession with the number of independent stations in operation, and the off-network restriction's role in maintaining their ranks. This causes LECG to be preoccupied with "economic gaps" among the different stations, as measured by differences in audience ratings and rates of return on sales. We are invited to believe that a fall in ratings or profitability necessarily implies a reduction in economic wealth, and so warrants a policy that prevents these changes.

Nowhere are we given any indication that tradeoffs exist in the pursuit of this atomistic industry structure. In that sense the LECG report fails to respond to the Commission's call for

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[17] While production of programs does incur substantial initial development costs, and while episodes in a television series may have roughly constant marginal cost, that marginal cost is not negligible. A typical half-hour prime time series will cost in the vicinity of $600,000 per episode. See LECG, p.71, footnote 38.

[18] Curiously, LECG (p.9) quotes from Owen and Wildman (1994) "Private production of a public good sometimes *requires protection of the producer from entry or competition.*" (Emphasis added.)

a "weighing of [the rule's] costs against its benefits."[19]

The costs of protection include the additional expense of continued production by high-cost firms who survive only because of regulatory protection. Firms who, but for continued protection, cannot recover their costs, not only incur high direct costs, but divert production away from lower-cost rivals. Efficient independent stations are penalized alongside network affiliates if the off-network restriction permits inefficient independent stations to survive in the market.

Healthy competition results in a process of natural selection over time. Inferior technologies are replaced by superior technologies, organizational forms undergo responsive changes, even entire industries may disappear. Competition weeds out the inefficient and invites entry by those who believe that they can offer a viable package. Efficient independents who have gained considerable programming and operating experience over time do not rely on the artificial protection of PTAR; inefficient independent stations, by contrast, require continuing artificial protection. LECG proposes to give it to them.

LECG explicitly states that the recent effects of competition on independent stations is cause for regulatory protection. Incredibly, they ascribe to PTAR the goal of penalizing cable for its success in attracting audiences away from broadcast television,[20] and view the repeal of PTAR as a source of "competitive disadvantage" for independent stations. While marginal independent stations may exit following repeal of the off-network restriction, this move simply eliminates what is a "regulatory advantage" that inefficient independent stations have been enjoying for far too many years.

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[19] NPRM, ¶32.

[20] Id., p.95.

B. The Market Is Not "Biased" Against First-run Programming As LECG Claims

The LECG report claims that there is an inherent market bias creating a disadvantage for first-run syndicated programming relative to off-network programming. It concludes that PTAR's off-network restriction is needed to prevent first-run syndicated programming from being driven from the access period. On the contrary, we see no reason to believe that the market mechanism is incapable of efficiently allocating these programming products. We find plausible conditions for first-run syndicated programming to win the sale to a particular station over an off-network program, and vice versa. LECG's reasoning is simplistic and incomplete.

At the heart of LECG's analysis is the difference in sunk cost of producing off-network and first-run syndicated programming. According to LECG, suppliers of off-network programming would willingly reduce their asking price down as far as avoidable cost which, in the case of off-network programming, is just its distribution costs. In contrast, they claim that producers of first-run syndicated fare must recover the per-episode production cost. They conclude that off-network program distributors will always match or undercut any offer made by first-run syndicators.

As a matter of economic principle, this argument is wrong for two main reasons. First, LECG assumes that program suppliers have but one outlet for their programming: they sell to a station that does not face competition from other program purchasers, *i.e.*, the station is a monopsonist. Second, it treats program sales between broadcasters and program suppliers as one-time transactions. Relaxing either of these two unrealistic assumptions will result in equilibrium program prices that do not have the feature suggested by LECG. In fact, we can show that even within LECG's static, monopsony framework, off-network distributors will not be able to outbid first-run syndicators.

To see this more formally, we construct a simple model of the determination of equilibrium program pricing.[21] Let v_N and v_S be the value that a particular broadcast station attaches to an off-network and a first-run syndicated program, respectively. These values are essentially advertising revenues net of associated operating costs. Furthermore, let c_N and c_S be the avoidable costs to the program owner of the two kinds of programming. Included in these cost figures are production and distribution costs incurred after the program sale is complete.

If an off-network and a first-run program compete for exhibition on a single station, lacking alternative outlets in that market for their programming, and remembering that this is a one-time sale, they will bid down asking prices until one of the two can no longer cover its avoidable cost. Letting p_N and p_S represent the asking prices for the off-network and first-run syndicated programs, the station will choose the one that provides the higher net return, *i.e.*, it will compare $v_N - p_N$ and $v_S - p_S$. If both types of programming deliver the same value to the station (*i.e.*, $v_N = v_S$), then the one with the lower cost could win the bidding by reducing its price down its rival's avoidable cost.[22] So, for instance, if an off-network program has a lower avoidable cost than a first-run syndicated program (*i..e*, $c_N < c_S$), then the off-network distributor will sell to the station at a price equal to (actually, slightly less than) the first-run syndicator's avoidable cost (*i..e*, $p_N = c_S$).[23]

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[21] LECG's model does not establish equilibrium prices for programming. Their Equations III.1 and III.2 are merely cost accounting relationships that describe breakeven conditions for program suppliers. More precisely they are called "individual rationality" constraints in bargaining theory.

[22] It would accomplish this by offering terms that would pay a small amount over the profits realized by the station if it were to buy the high-cost alternative.

[23] The best offer that the first-run syndicator can make the station (without incurring a loss in this one period) is to set price at its avoidable cost: $p_S = c_S$. The off-network distributor is able to charge slightly less and still break even, in which case price is $p_N = c_S$ and the station earns a return of $v_N - c_S$.

In reality, however, first-run syndicated programming has an advantage over off-network programming due to the greater audience appeal of first-run exhibition. An off-network program, after all, typically has been exhibited twice during its network run. Furthermore, the popularity of first-run programming in any given time slot will translate into additional advertising revenues by registering higher audience ratings in subsequent time periods (the "audience flow" effect). For these reasons, first-run programs could deliver greater surplus than off-network programs provided their cost are not too different: $v_S - c_S > v_N - c_N$. In that case, price will be just low enough to entice the station to select the first-run syndicated program: $v_S - p_S \geq v_N - p_N$. Since the off-network distributor–assuming it has no other opportunity to make a sale in this market–would cut its price down to cost (*i.e.*, $p_N = c_N$),[24] the equilibrium price will be: $p_S = v_S - (v_N - c_N)$. Notice how equilibrium price depends on the quality differential between the two programs, and not just on program costs.[25]

The above model, like the analysis in LECG's report, turns on the presence of a single station that purchases programming when, in fact, distributors can sell their programs to other stations in the same market and to stations in other markets. In that case, program prices will also reflect the supplier's opportunity cost of a foregone sale to some other station. The station and the program supplier will negotiate over the division of the available surplus which is the difference between the program's value to the station and the sum of the program supplier's avoidable and opportunity costs. The greater the outside opportunities possessed by the program

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[24] In fact, the off-network distributor may not willingly reduce its price in a particular market if, because it employs uniform prices across some or all markets, it must offer the price reduction to stations in other markets as well.

[25] In fact, the avoidable cost of off-network programming is far from negligible. There can be significant marketing costs associated with placing an off-network program in syndication and then promoting it when it comes on the air. In addition, if "residuals" paid to programming talent for syndicated distribution are conditional on the number of sales, then this incremental amount should be included in the avoidable cost of off-network programming.

supplier, the higher the price paid for the program.[26] As a natural consequence, markets with many more stations will naturally pay more for both kinds of programming because suppliers have more outlets to turn to.

In fact, there is reason to believe that the opportunity cost to first-run syndicated programming is higher than for off-network programming. Specifically, stations' desire to "counter program" will raise demand for first-run syndicated programming because off-network fare, by and large, tends to be a fairly homogenous mix of sitcoms and dramas. As a result, first-run syndicators can be in a strong position to undercut off-network distributors, contrary to LECG's conclusion.

The LECG report continues its faulty reasoning even when it attempts to take a more dynamic view of programming markets. It correctly posits that program producers will undertake a project if and only if expected revenues cover all costs over the long run. Consequently, producers of first-run syndicated programming, the analysis claims, are disadvantaged because they must recover development, production and distribution costs, all inflated to reflect the increased likelihood of a failure, whereas off-network programs need only cover distribution costs, plus whatever portion of its "deficit" remains after its network run.

This calculation understates the revenue potential of first-run producers. In particular, it neglects the licensing revenues that the program can earn through subsequent renewal and

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[26] For instance, when a first-run syndicator places its program on a station, it creates value net of avoidable cost equal to $v_S - c_S$. In no way, however, will the syndicator accept an amount less than the opportunity cost of selling the program to some other station. As a result, the two bargain over a surplus in excess of the program supplier's "threat point" equal to the net return it would earn from the alternative transaction, say o_S. The bargaining results in a division of the surplus that is available to the two bargainers: $v_S - c_S - o_S$. Assuming the first-run syndicator receives a fixed proportion of this surplus, its program will command a price that increases as its outside options improve. Of course, the station also has outside options that should factor into equilibrium bargaining in a similar fashion.

reruns. Considering the simplest possible case, we can express the surplus potential of a new first-run syndicated series using the notation developed above:

$$v_S^1 + v_S^2 - (F_S + c_S^1 + c_S^2)$$

where now v_S^1 and v_S^2 represent the (present) value of the first-run syndicated program to the station in the first and second years, c_S^1 and c_S^2 are the associated (discounted) production and distributions costs in those years, and F_S is the upfront costs of developing the syndicated series. A second year of revenues relaxes the profit constraint that LECG places on first-run syndicators. In particular, as with the typical network program, a first-run program could incur a "deficit" in its first year of syndication (*i.e.*, $p_S^1 < F_S + c_S^1$) and yet earn a profit overall.[27]

Following the logic of LECG, we would expect to find many markets that experience a dearth of new products introductions because they cannot compete with used versions of similar products. Consider the case of book publishing. Expected revenues from new books must cover their development costs as well as their printing, marketing and distribution expenses. Furthermore, few books are ever financially successful. According to LECG, however, few new book publishers or authors would be interested in entering this field because they are unable to make money. They cannot compete with existing titles already in publication plus the many titles available as used copies which will hold down prices to avoidable cost. Despite the fact that thousands of new books are written and published each year, and new book publishers spring up all the time, would LECG recommend protection of book publishing for the same reason they believe that PTAR is necessary to subsidize first-run syndicated programming?

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[27] While off-network programs also run for several years, they tend to provide less value than first-run for several reasons. One important reason is that first-run is less risky provided stations sign shorter contracts, which they do. In that case, a station can renew a first-run series based on whether it turns out to be popular. Off-network programs may have a track record from their network run but they are typically contracted for 5-6 years in syndication. See LECG, p.71. Furthermore, there are many examples of highly successful network series that did not fare well in syndication.

C. LECG Fails to Establish an Economic Rationale for Continued Protection of Independent Stations and Emerging Networks

In our earlier Comments,[28] we recognized the potential economic benefits that could come from supporting "infant firms" that otherwise would not survive in the television industry. We acknowledged that the off-network restriction could promote this objective, but with the important proviso that such protection eventually expires. We observed that twenty-five years is a long enough time for infant firms to establish themselves as viable competitors, and we furthermore added that no guarantee of survival should be extended to all firms. Marginal, inefficient firms should be permitted to fail.

In its report, LECG repeatedly argues for protection of independent stations and emerging networks, yet never provides any efficiency justification for such protection. They point out that more independent stations will apply downward pressure on advertising prices,[29] but stop short of comparing any benefits from such competition with the costs of supporting these additional firms. They also allude to entry barriers facing emerging networks without ever specifically describing their nature or how the off-network restriction reduces them.[30]

LECG's report fails to mention any of the legitimate efficiency rationales for infant industry protection, much less apply them in this particular setting. It does allege a market failure that it believes stems from certain public goods aspects of television markets. Setting aside for the moment the mischaracterization of the economics of these markets, the report does not proceed to draw any connection between the alleged market failure and the need for infant

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[28] See especially pp. 18-21.

[29] LECG, p.4.

[30] Id., pp.91-95.

industry protection.

Nor do we ever learn why PTAR's specific restrictions are the most effective means of achieving the benefits of additional entry into this industry. Alternative mechanisms for promoting infant firms (*e.g.*, direct subsidies) are never discussed, nor are they shown to be inferior to PTAR. We are also not given any indication of when PTAR's protection should be removed. As one protective need leads to another, does LECG envision protection being justified indefinitely?

LECG's preoccupation with subsidizing large numbers of firms carries over to emerging networks. Once again, we are given no efficiency justification for protecting and promoting these firms. Nor does LECG answer the Commission when it asks "whether any inefficiencies of encouraging entry of new networks by placing limits on incumbents are outweighed by real benefits."[31]

The Commission fully recognizes that a possible by-product of the rules is the creation of new networks.[32] In fact, today's emerging networks (Fox, UPN, WB) were created out of the stock of existing independent stations. That should not, however, imply that even more networks are necessarily beneficial, in turn requiring ever more independent stations. The competitive process in an industry that is now 50 years old should be allowed to add new independents stations and broadcast networks as permitted by market growth and technological advances. Innovative firms should have the opportunity to displace inefficient incumbent networks by providing superior programming and innovative services. This is happening today as Fox approaches parity with the three networks, and as cable and DBS become viable

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[31] NPRM, ¶49.

[32] NPRM, ¶__

competitors in the delivery of television programming.

D. LECG Ignores the Economic Distinction Between PTAR's Two Restrictions

LECG claims that economic markets in the broadcast television industry should be delineated based on expenditures for national video advertising. We find this to be an appealing approach, but in LECG's hands, it is improperly applied. If advertising distinguishes markets, then LECG should examine advertisers' willingness to substitute across time periods. Instead, for example, it lumps together the access period with regular prime time without any attempt to compute advertisers' cross price elasticities between the two time periods. It is entirely possible that many advertisers–given a desire to target young viewers–view the access period as a closer substitute to certain daytime periods than to regular prime time.

A more serious mischaracterization of broadcast markets underlies LECG's claim that communities of all sizes should be considered as one for the purpose of first-run syndicated program sales. As a result, they conclude that if first-run syndicators are not shielded from competition in the top 50 markets, they will be unable to sell in the remaining markets despite the fact that they successfully do so today.

First of all, LECG once again ignores its own prescription to use advertising as the common denominator for broadcast markets. They merge the top 50 markets with all other markets based on the pattern of programming sales in the two market segments; they do not consider whether the two markets segments are distinct based on advertisers' willingness to shift advertising between the two.

Instead, LECG points to the fact that the percentage of sales of five King World programs (apparently syndicated during a single season) accounted for by stations in the top 50

markets falls over time from the date of the initial offering.[33] They interpret this to mean that stations in small markets refrain from purchasing first-run syndicated programs until stations in the top 50 markets do so.

LECG does not consider different explanations for this sales pattern. For one, a station in a larger market will bid more aggressively for any given program because it invariably competes with more rival stations than a typical station in a smaller market (as we argued above). The sales of a first-run program, therefore, will tend to occur sooner the greater the number of stations competing for it.[34]

Another alternative explanation for the sales pattern observed by LECG derives from the supply side of this market. We can expect that the marketing and distribution expense of first-run syndicated shows are independent of market size. Revenues, on the other hand, are increasing with the size of the market, resulting in higher margins on sales in the larger markets. In response, we would expect first-run syndicators to expend more effort to place their programs in the largest markets before their off-network competitors. With limited marketing resources, they rationally delay their attempts to make sales in the smaller markets.

More importantly, LECG uses the observed sales pattern to obfuscate the distinction between PTAR's two restrictions: the off-network and the network restrictions. In their reasoning, whether the network is allowed to program the access period is immaterial: first-run

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[33] Cf., LECG, Figure IV.3.

[34] Furthermore, in very small markets with very few firms, there may be no purchase at all of a certain first-run program. This fact is revealed in LECG's data. While the top 50 markets make up about 20% of the television markets, over the long run they account for 42% of the purchases of the King World shows. Looked at differently, the 200 or so small markets make up 80% of the markets but account for only 58% of the sales. Thus, some stations are simply not in the market for these King World first-run syndicated programs, and to include them in the sample is part of the reason LECG sees the top 50 markets with such a high proportion of the purchases.

syndicated programming will not have the opportunity to compete with network fare because it will be consistently outbid by off-network programming. We have exposed LECG's reasoning as defective: first-run syndicated programming can compete with off-network programming and it can do so in all markets.

Their conclusion that only the off-network restriction matters, and that imposition of the network restriction is extraneous, is incorrect. In our Comments,[35] we carefully describe how the off-network restriction primarily operated to promote the viability of independent stations, while the network restriction was aimed at opening markets for independent program producers. LECG never reaches this distinction because they restrict their consideration to the off-network restriction's effect on the first-run syndicated programming market.

III. CRITIQUE OF THE EMPIRICAL ANALYSIS IN THE LECG AND EI REPORTS

A. Overview

In this section we examine the derivation and significance of empirical claims made in the LECG and the EI reports. Again our principal focus will be on the LECG report and the data on which it based its statistical claims. One of us (Woroch) was given access to a portion of LECG's database under the limited terms of an agreement among the parties to this proceeding. This provides the basis for many of our remarks about LECG's empirical analysis.

Overall, these reports fail to establish an empirical foundation for their assertions about the efficiency effects of PTAR. Both reports are preoccupied with stations' ability to attract

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[35] Id., pp.__.

audiences but (with one exception) make no attempt to translate these observations into measures of viewer welfare. None of the estimated models are deduced from economic models that could be applied to explain the behavior of the television industry. Indeed, we are never told what conceptual model underlies each empirical specifications. It is possible to discover correlations between ratings and rates of return and other industry variables without ever learning anything about the underlying structure of the television industry. And granting the existence of some systematic relationship, it is still unclear how the LECG and EI models could assist the Commission in its pursuit of policies that promote efficiency given the highly specialized, reduced form of their estimated equations.

Contrast this approach with the work of Noll, Peck and McGowan (1973) who, starting with an economic model of viewer decision making, derive estimates of the dollar value to viewers of the availability of various combinations of affiliate and independent stations. In fact, we will expose EI's misuse of that model shortly, but it should nevertheless be recognized as a legitimate empirical approach to welfare analysis of these markets.

Implicitly, LECG (and EI, to an extent) assumes that their measures of independent station performance–NAB rates of return on sales and Arbitron rating points–are positively correlated with social welfare. No strict relationship between the two necessarily exists. In fact, high profits can signal poor performance of an industry. Moreover, low television audience ratings (as opposed to audience shares) could simply reflect superior performance of a competing industry, in this case the cable industry. PTAR, however, was not designed to protect independent stations against non-broadcast competition.

LECG's preoccupation with the performance of independent stations is pervasive. In no instance are we provided with estimates based on a sample of network affiliates. This makes drawing conclusions from the empirical estimates a hazardous undertaking. We will see, in fact,

that applying LECG's specification to a sample of network affiliates in some cases confirms the results found for independent stations(showing that they are not special) and in other cases reverses the effects entirely (casting doubt on the econometric specification itself).

A failing throughout LECG's report is the absence of any distinction among the different independent stations. Some independents are efficient, effective competitors while others are truly marginal. This is obvious just looking at the distribution of ratings across independent stations. A large group of independents produce extremely low ratings across all time slots. Then there is a group of independent who consistently register healthy ratings numbers.

It is important to account for such differences because large established firms and small marginal firms have different impacts on the performance of an industry, and call for different policy prescriptions than one composed of firms roughly of the same size. Instead, LECG lumps all independents together by taking market-wide averages for rates of return and for ratings. Some accounting for these differences, and the differential impact of PTAR, is necessary. We will show how various measures of a station's "age" will be a powerful explanatory variable for the effects of PTAR.

Our analysis of LECG's empirical findings will proceed along two paths. The first will examine the model developed by LECG to check the validity of their empirical claims. The second will branch out into what we believe to be a more satisfying conceptual approach to the relationships being examined by LECG. In the next two sections we will examine some of the details of the basic approach taken by LECG and then retrace their steps in their ratings equation. Following this, we turn to our alternative approach which, while not departing radically from the one in the LECG report, results in vastly different conclusions. In the end, it is difficult to see how the LECG empirical results could provide any guidance in developing an economically rational policy toward television markets.